

Air New Zealand Limited
Submission to the Ministry of Economic Development

Options for Further Work on
Airport Regulation Proposed for 2008/09



AIR NEW ZEALAND

Submission

14 March 2008

Introduction

1. Air New Zealand (**Air NZ**) welcomes this opportunity to submit its views on the Ministry of Economic Development's (the **Ministry**) Discussion Paper '*Options for Further Work on Airport Regulation Proposed for 2008/09*' (the **Discussion Paper**). The Discussion Paper identifies three options in relation to further workstreams agreed to in the November Cabinet paper.
2. The consultation is highly unusual, for whilst the Ministry indicated its intentions in January 2008, it takes the surprising step of identifying options which contradict Cabinet decisions taken only a few months ago and which endorsed recommendations that were the product of a lengthy and comprehensive consultation exercise undertaken by the Ministry.
3. Nevertheless, Air NZ wishes to fully cooperate with the Ministry in its further consideration of the need for a comprehensive study into the scope and form of airport regulation in New Zealand. However, Air NZ is of the view that very compelling reasons, or a material change in circumstances, need to be demonstrated if the November Cabinet decisions are now to be reversed.

Executive Summary

4. Air NZ supports the original position (option 1) of completing the study and addressing both workstreams identified in the cabinet paper.
5. Option 2, the scaling back of the study to commercial airports except AIAL, WIAL and CIAL, is a step backwards. The opportunity for a study to encompass all airports and for a holistic and conceptual review of airport regulation in New Zealand was a welcomed development and one that the Government should not now pass up on.
6. To do no further work (option 3) cannot be viewed as a credible option. The balance of risk, given the costs to consumers of failing to have appropriate regulatory oversight where needed, favours further investigation and analysis. The efficiency of the airport sector, when one considers the role airports play in regional economies and the wider New Zealand tourism industry, is far too important for the Government to "shut its eyes" to and hope that no problem exists.
7. Only a comprehensive study of all airports will assist Ministers and policy makers in understanding the issues that exist and inform them in their current and future policy decisions. Air NZ encourages the Government to advance both workstreams of the study as set out in the cabinet paper.
8. In this submission, Air NZ makes the following six key points:
 - a) The decision to place AIAL, WIAL and CIAL under price monitoring regulatory control was conservative in 'scope' and 'form' and therefore conditioned upon a wider and more comprehensive study of the airport sector.

- b) The regulatory uncertainty that could exist during the airport study would not appear to be of such magnitude as to warrant abandoning an airport study. In any event, whatever regulatory uncertainty could be said to be created in undertaking the study, is clearly outweighed by the benefits of a comprehensive and timely study capable of determining the most suitable and sustainable regulatory framework for airports in New Zealand (and thereby delivering regulatory certainty in the future).
- c) A holistic approach to considering the natural monopoly characteristics of New Zealand airports is needed and overdue.
- d) Information disclosure and price monitoring as a form of control is complementary to other forms of regulation. Any preliminary work in establishing such a regime will be of assistance in developing alternative forms of regulatory control (should that be the outcome of the airport study) and is not at risk of being redundant.
- e) A study of only regional airports risks being overly influenced by the nature of control that will be applicable to the three largest airports. Similarly, the lack of an airport study means that the opportunity to design the most appropriate form of regulation for all airports is missed.
- f) Regional airports remain unchecked natural monopolies in need of greater regulatory oversight. In addition to our comments below on regional airports, we attach as an Annex a summary update of Air NZ's recent dealings with seven regional airports which underscores the urgent need for greater regulatory oversight of regional airports.

Cabinet decisions to place AIAL, WIAL and CIAL under regulatory control were both conservative and conditioned upon a wider and more comprehensive study of the natural monopoly issues arising with airports.

The decision to impose price monitoring and information disclosure regulatory control over New Zealand's largest three airports was a conservative decision. Having found that the existing regime governing all airport pricing was "not a credible or robust regime" and that the prospect of excessive pricing at airports was real, Ministers recommended control only over the three largest airports and then only elected to adopt the least intrusive form of regulatory control possible (information disclosure & price monitoring).

While it was a step forward, it must also be considered something of a "stop-gap" measure from the perspective of users pending further analysis of the issues. Had the proposed study not been provided for in conjunction with the introduction of information disclosure and price monitoring, Ministers may well have given further consideration to, or sought to separately consult on, the desirability of other forms of airport regulatory control (in particular negotiate/arbitrate). Such an avenue was not taken, quite reasonably, on the basis that the most appropriate form of control was to be expressly addressed as part of the proposed airport study.

On the basis that decisions relating to establishing airport regulatory control and the proposed airport study workstream were taken together, they are clearly linked. As such, it remains critical that the airport study is undertaken as originally provided for

otherwise what could be regarded as an interim measure, does risk becoming a permanent arrangement.

It is therefore neither appropriate for the proposed study to be scaled back (option 2) or abandoned (option 3). Either option undermines the basis of other decisions taken by Cabinet, most critically the decision to only impose information disclosure and price monitoring and only over the three largest airports.

It is not credible to abandon a regulatory investigation on the basis of investor uncertainty, particularly as the need for regulatory change has been well signalled by Cabinet and input methodologies are to be transparently developed by the Commerce Commission.

Air NZ understands from the Discussion Paper that the main concern underlying the Ministry's willingness to consider options 2 and 3 is the regulatory uncertainty that may exist while the study is completed and final recommendations considered. In this regard, we make the following comments:

- It is unrealistic to scale back a regulatory investigation on the basis of the regulatory uncertainty created. 'Regulatory certainty' as a principle generally refers to the level of confidence a regulated firm can have in an already established regulatory framework. As a principle it cannot be logically applied to an initial investigation as to whether regulatory control is warranted and, if so, how best can this be achieved. Were regulatory certainty to always be the goal of any regulatory framework, there would never be any regulatory investigations or consideration given to regulatory reform.
- In any event, regulatory uncertainty must be seen as fairly minimal given the accelerated timetable proposed. In contrast to the 2002 Airports Inquiry which was protracted over many years, the proposed timeframe for the airport study is to have Cabinet recommendations within fifteen months from today. The study proposal offers considerably less uncertainty than compared to a Part 4 inquiry under the Commerce Act.
- The airports study is capable of delivering greater certainty to airport investors in AIAL, WIAL and CIAL earlier than the implementation of information disclosure and price monitoring under the Commerce Act. The Discussion Paper suggests that the Commerce Commission will only assess post-2012 airport prices, and the outcome of such an assessment be only then implemented for a 2017 price reset. The uncertainty surrounding a comprehensive study to be completed within the next year or so appears minimal as compared to the uncertainty of what may ultimately be the regulatory framework in 2017.
- Any uncertainty that could be said to exist during the period of the airport study will clearly be mitigated by the transparency created through the Commission's commencement of work on input methodologies. Similarly, the proposed legislative detail of the four types of regulatory control under an amended Commerce Act will shortly be known to all investors and this will further act to mitigate regulatory uncertainty.
- The level of regulatory uncertainty around the already announced reforms does not appear to have deterred investors (at least in AIAL) since the

Government's announcements to make AIAL subject to regulatory control under the Commerce Act. Since the Government announced its intentions to place AIAL into regulatory control and to undertake a comprehensive study of potential airport regulation in New Zealand, at least two bidders have contemplated or embarked on major share acquisitions of AIAL. Investors can (and clearly have) shown willingness to factor in the possibility of regulatory change into their analysis and cannot be said to have been deterred.

A holistic approach to considering the natural monopoly characteristics of New Zealand airports is overdue.

Air NZ welcomed the original decision in the cabinet paper to investigate airport regulation, at both international gateway and regional airports, as an opportunity to provide a holistic, rather than piecemeal, approach to airport regulation in New Zealand. While the international gateway airports are clearly larger in size, regional airports remain part of the wider airline network and remain critical for both domestic and international passenger flows.

Only option 1 will provide an opportunity for a holistic and consistent framework to be applied to New Zealand airports. A consistent approach to airport economic regulation would be a major simplification as compared to the existing situation. Excluding the proposed amendments to the Commerce Act in 2008 for AIAL, WIAL and CIAL, there already exists three separate pricing regimes for New Zealand airports.

Were the study to only investigate regional airports (option 2), the outcomes simply risk further entrenching an overly complicated, piecemeal approach to airport regulatory oversight in a small economy. The Discussion Paper correctly recognises that very little analysis of regional airports has ever been undertaken and, despite being natural monopolies, they have never had either their pricing or investment decisions made the subject of an adequate or transparent regulatory framework.

Air NZ encourages Ministers not to resile from Cabinet's original decision to undertake a comprehensive, all encompassing study and with a view to establishing a relatively uniform set of principles to apply to airports in New Zealand.

Information disclosure and price monitoring is complementary to other forms of regulation. Were alternative forms of regulatory control to be imposed following the study, the preliminary work undertaken in establishing the regime over the same period would not be redundant.

The Discussion Paper suggests it may be inappropriate (or be imposing unnecessary cost) to instigate the wider study. Air NZ does not accept this as a valid reason to either abandon or scale back the study to just the regional airports.

The preliminary work of both the Commission and the regulated airports over the next year is likely to be of considerable assistance in establishing any alternative forms of regulatory control. The risk of redundancy of the work would therefore appear low.

A study which simply addresses regional airports (option 2) risks being artificially constrained by the already decided form of control for AIAL, WIAL and CIAL.

A study that simply addresses regional airports (Option 2 and not AIAL, WIAL and CIAL) risks being constrained simply to a study of whether regional airports should be subject to an information disclosure and price monitoring regime under the Commerce Act.

In theory, such a study ought to commence from the viewpoint of considering what type of control would be most appropriate for regional airports. However, in practice, the study's authors would find it difficult to ignore the fact that the three largest airports are, and would remain, subject to an information disclosure and price monitoring regime. If regulation of regional airports was considered appropriate, then the presence of information disclosure and price monitoring as the default option, risks artificially limiting the possible outcomes of such a study.

Regional airports remain unchecked natural monopolies in need of greater regulatory oversight.

A natural monopoly is a natural monopoly, regardless of its size. The need to consider regulation of both large and small natural monopolies is recognised in other industries, including New Zealand's electricity lines company regulation. The existing Part 4A of the Commerce Act covers some 29 electricity lines companies, of very different size and ownership structures.

The case for examining the price and non-price behaviour of regional airports has also increased in the last few years as many have sought to mimic the pricing and asset valuation practices of the three larger airports. This is a very serious concern and underscores the need to address the same issues in the context of regional airports.

Finally, Air NZ would highlight that little comfort can be drawn from the fact that pricing decisions of some regional airports are subject to Minister of Transport approval. It is Air NZ's experience that the Minister, in approving the airport pricing of joint venture airports under the Airports Authorities Act does not expressly apply efficiency criteria to either pricing or investment decisions but rather applies only the same "consultation" standard underpinning the regime in place for AIAL, CIALK and WIAL which was concluded to be "not a credible or robust regime". The Minister is given no other legislative guidance in relation to such decisions.

In completing the airports study as agreed by Cabinet, important information regarding the efficiency of both pricing and investment decisions in these regional commercial airports would be scrutinised for the first time. Regional airports cannot continue to exist in a vacuum. Policy makers need to understand what is happening at these regional, but still significant, airports.

To assist Ministers in better understanding some of the price and non-price issues that Air NZ believes are of concern in regional airports, we have set out (in Annex 1) a short summary of some of the issues that have recently arisen in some key

regional airports' pricing discussions with users. This is an updated version of Annex 5 that was attached to our July 2007 submission on the original discussion document.

As the Ministry will appreciate from these short summaries, very real issues exist with respect to pricing and investment decisions of regional airports and the issues are of sufficient importance to warrant the type of study originally envisaged in the cabinet decisions.

Conclusion

There is too much at stake for the Government to overlook the need for a comprehensive review of airport regulation in New Zealand. Airports are vital bottleneck infrastructure facilities with massive flow on effects to regional economies, tourism etc. The need for efficient pricing and appropriate investment by all airports is of vital interest to all consumers and warrants a full and comprehensive analysis of the type Cabinet originally demanded.

Air NZ (and the Board of Airline Representatives of New Zealand) have repeatedly expressed their misgivings about New Zealand's airport regulatory environment for over a decade. Many of the issues that have arisen over that period were readily foreseen and experience has only reinforced the concerns held.

An opportunity exists to address these issues in a comprehensive manner and Air NZ believes that this opportunity should be pursued vigorously by Ministers and officials. An apathetic response to following up the decisions made by Cabinet late last year is the last thing that should now occur.

Annex 1 Regional Airports and recent pricing discussions with users

During 2006 and 2007 the Regional Airports set out below engaged or continued engagement with users in pricing discussions.

At a local level there is mounting pressure from local body politicians in several regional airport locations to drive over-investment in facilities with an expectation that despite the low volume of the domestic base, today's users will finance any expansion, regardless of need and regardless of the economic impact of higher travel costs on demand. Of course, the regions are entitled to have high goals and aspirations for regional air services. However, in many cases this is not tempered by an in-depth knowledge of the wider operating environment including any genuine understanding of basic airline economics, the influences on network structures and, in turn, the likely commercial sustainability of various types of air services.

There is also an unrealistic presumption that full economic returns can be made on what, in many cases, are substantially sub-scale operations. Today's airport users are in effect faced with the constant risk of effectively underwriting well meaning but poor commercial decision making. A growing number of airports are also turning to development levies as a means of financing works that may in fact never be required by airlines or passengers.

During 2006 KPMG produced, under contract to MOT, a report intended to guide the Ministry in developing a framework for regional airport pricing. This report highlighted the problems confronting the tradeoffs between regional need, low volume operations, infrastructure costs and the challenge of achieving "commercial returns" in regional locations without necessarily proposing solutions.

New Plymouth Airport.

A joint venture airport with Government and New Plymouth District Council (NPDC) as partners.

A low volume, sub-scale airport that averages 12 scheduled airline services (600 seats) per day.

The process of resetting charges over a long period of time at New Plymouth had been constrained by a lack of consultation and during 2006 NPDC set about a new consultation. The building block methodology employed used a valuation approach that had not previously been used and that resulted in an increase in land values of 114% in 2 years, a failure to treat revaluation gains as income and ultimately a price for 50 seat aircraft that was equivalent to that paid for Domestic jet aircraft landing in Auckland. Non land asset values were assessed to have increased by 31% over 2 years using a creative ODRC methodology.

Over time the parties agreed that a single till, depreciated historic cost based approach was more appropriate and an agreement was reached that provided a fair return on assets to the owners.

The Minister of Transport has subsequently approved the charges and these have been gazetted.

Nelson Airport.

Nelson Airport is a Nelson City Council owned company operating the airport on leased land restricted to airport use only.

Proposed charges are based upon a multi-till methodology and re-valued assets with understated flight and passenger forecasts. Revaluation gains are not being treated as income. If revaluations were to be treated appropriately and reasonable growth forecasts adopted, current Nelson Airport charges would reduce.

During the consultation Air New Zealand raised a number of issues that remain unresolved. Consultation was terminated unilaterally by Nelson Airport Ltd and using the powers available to it under the Airport Authorities Act to set charges as it thinks fit, has implemented the proposed charges.

Absent any other avenue open to Air New Zealand but to litigate the outcome, the company has filed an application for judicial review of the charge setting process.

Napier Airport.

A low volume sub scale joint venture airport currently undergoing corporatisation. Under the joint venture structure the Minister of Transport must approve any new charges. Once corporatisation is complete the airport company will be able to rely on a statutory power "to set charges as they think fit".

Napier Airport has applied a multi till revaluation methodology to proposed charges without taking revaluation gains to income. Additionally assets valued using an ODRC basis have not been optimised.

The consultation process was (in Air New Zealand's view) seriously flawed and resulted in litigation against HBAA and the Minister of Transport. The recent judicial review ruling with respect to this litigation was appealed by Air New Zealand. The appeal was upheld and charges have reverted to 1998 levels. The appeal court observed that officials (and, by implication, the airport company) had not provided the Minister with a fair, accurate and adequate description of the situation to enable the appropriate decisions to be made by the Minister.

HBAA also continues to progress its aspirations to undertake extension of its main runway to attract international operations. An estimate of costs to achieve an extension is approximately \$10million. Costs to provide suitable compliant facilities for international passengers, Customs, Quarantine and Security services is in the order of \$5 million - \$10 million, with labour costs to be borne by the airport for new international services also adding to the costs of operation. Part owner Hastings City Council, has passed a motion approving a \$5 departure levy to fund the extension prior to any consultation with users. As no international services currently exist at Napier, the potential for domestic passengers to meet the cost of what is utterly speculative international expansion is very high.

Gisborne Airport.

Gisborne Airport is wholly owned by the Gisborne District Council (GDC) and leased for \$90,000 p.a. to Eastland Infrastructure Limited (EIL).

EIL is privately owned and does not currently hold “airport company” status under the Airport Authorities Act. It has no legal right to set airport charges.

GDC is an authority under the Airport Authorities Act and is the charge setting authority for Gisborne Airport.

Notwithstanding its non airport company status EIL proposed to set new airport charges during 2006. The underlying assumptions used to develop the new charges (somewhat higher than those for similar facilities at comparable New Zealand locations) were not transparent to users. Attempts to negotiate a solution with EIL were unsuccessful.

In September 2007, GDC passed a by-law imposing charges requested by EIL which are based on a multi-till methodology and revaluations of assets not owned by EIL. Air New Zealand has questioned the legality of the consultation and charge setting process followed by GDC and high potential exists for a judicial review of the process.

With the assistance of the Gisborne Chamber of Commerce Air New Zealand has proposed an interim pricing regime to EIL (pending the outcomes of the Commerce Act review).

Despite lacking airport company status EIL continues to assert it has the right to set charges as it thinks fit.

Hamilton Airport.

Hamilton Airport is an “airport company” under the Airport Authorities Act and is owned by Hamilton City and four Waikato-based district councils.

Hamilton Airport last consulted on charges prior to the Airport Authorities Amendment Act 1997 which required all airports that had not consulted in the prior 5 years to consult with their customers within 12 months of its enactment, (which Air New Zealand agreed to for 12 months) but failed to fulfil its consultation obligations for a number of years following the agreed waiver period. Air New Zealand sought a full consultation on all aspects of proposed pricing at the airport in October 2004 but no consultation on landing and terminal charges occurred until 2007.

During 2006/07 Hamilton Airport undertook a \$15 million terminal expansion project. The cost and scale of the project exceeded (by more than double) that required by Air New Zealand - a point communicated to Hamilton Airport on a regular basis prior to the project's inception and during its construction. Proposals for a smaller scale

less costly development were ignored/rejected by Hamilton Airport. Numerous attempts by Air New Zealand to consult on the costs and cost recovery intentions of Hamilton Airport were fruitless.

In 2006, Hamilton Airport announced its intention to consult on a \$5 Domestic Development levy. Air New Zealand reiterated its preference to pay directly for its requirements at Hamilton Airport without the imposition of a levy and again requested full charges consultation. Hamilton Airport imposed the Levy in January 2007. Air New Zealand filed an application for judicial review.

Hamilton Airport undertook a separate consultation on Airfield and Terminal Charges during 2007. The airport's proposal was based upon a multi-till approach, understated traffic forecasts, and the incorrect treatment of asset revaluations. At the same time that the airport was using asset revaluations to justify the proposed price increases, it also proposed that future asset revaluations would not be used to justify future price increases. It is clear that Hamilton Airport is over-capitalised and asset revaluations were being used as a tool to justify price increases.

A negotiated settlement was achieved which included a withdrawal of the application for judicial review of the Development levy process.

Dunedin Airport.

Dunedin Airport is jointly owned by Dunedin City Council and the Government and is an airport company (DIAL) under the Airport Authorities Act.

In 2005 DIAL commenced a terminal redevelopment that cost \$27million. The redevelopment was undertaken at the behest of the airport Board. Air New Zealand, the sole scheduled commercial operator at Dunedin, was consulted on functionality, but not on size or need for the re-development.

Despite numerous requests by Air New Zealand, DIAL declined to consult on terminal charges resulting from its development. Air New Zealand was required to vacate its leased areas to enable the development to proceed and, under duress, negotiated an Agreed Terms of Reference with respect to charges post terminal completion. DIAL's proposed charges now exceed the levels set out in that agreement by 100%.

Invercargill Airport.

Invercargill Airport is jointly owned by Invercargill Council and the Government and is an airport company (IAL) under the Airport Authorities Act.

Invercargill Airport is a low volume, sub-scale airport that averages 9 scheduled airline turbo prop services (468 seats) per day.

In 2004 in an attempt to attract international services IAL extended its main runway by 500 metres. To date no international operator has availed themselves of this capability. No capital has been spent to date on the requirements to satisfy Customs, Quarantine and Security requirements to support international operators, the costs of which, including labour, fall to airports not currently operating international services.

IAL must undertake a runway overlay by 2010 to ensure continued operations of turboprop aircraft. The cost of a 50mm overlay to enable continued turbo prop operations is approximately \$2.9million. Operation of any future international aircraft would require an overlay of 75mm at an estimated cost of \$4.8 million (inclusive of \$2.9 million).

Landing charges at Invercargill, already at the upper end for current aircraft types, will need to increase by an average of \$100 per landing or 38%.

Should IAL also seek to recover a WACC more representative of the larger airports (under the “act commercially” element of the Airport Authorities Act) charges will be higher than currently anticipated. Air New Zealand is working with IAL to achieve an economical solution

It is apparent however that the investment in speculative extension of the runway has been made at the potential expense of commercially sustainable air services.